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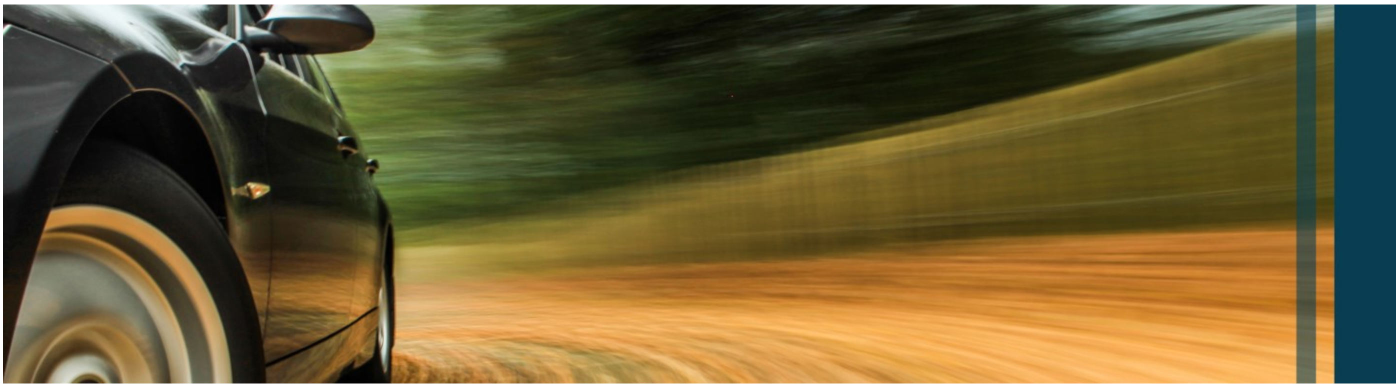

JANUARY 2017 – 2017: THE END OF ‘MEXICO’S MOMENT’ IN THE AUTOMOTIVE SECTOR?

Over the last two decades Mexico’s automotive sector has more than tripled in size. Mexico is now the seventh largest vehicle producer in the world and also the seventh largest producer of light vehicles, and the fourth largest exporter of light vehicles. Overall the automotive and auto parts industry in Mexico accounts for 3% of gross domestic product (GDP), 18% of manufacturing production, 20% of foreign direct investment (FDI) and 27% of total exports. Since the start of the administration of President Enrique Peña Nieto in 2012, investments in the sector have totalled USD 22.6bn, giving way to talk of ‘Mexico’s Moment’ in the automotive sector.

At the start of 2016 there was great confidence that this momentum would continue. The Mexican Automotive Association (AMIA) expected at least an additional USD 5bn investment over the next two years. It also maintained that Mexico would become the world’s sixth largest light-vehicle producer by 2020 or earlier, remain the fourth largest vehicle exporter and become the fifth largest automotive parts producer, surpassing South Korea.

There are multiple reasons for the recent dynamism of the Mexican automotive sector. A key one is low labor costs. Wages of auto workers averaged USD 3.90/hour in 2016, the lowest of the top 20 countries in vehicle production (by comparison, they averaged USD 33.23/hour in the US). Other key reasons have been growing – though still modest – domestic demand, an improved infrastructure, strong government support and a high presence of auto clusters. The latter have developed mostly in the northern and central regions of Mexico, often in industrial zones that are within short distance of each other.

However, probably the main reason for the impressive growth of the Mexican automotive sector has been a network of free trade agreements (Mexico has 11 trade agreements with 46 countries) and especially the North American Free Trade Agreement (NAFTA), which entered into force in 1994 and encompasses Mexico, the US and Canada. Against this backdrop, the US has become the main destination of Mexican vehicle exports (71%) and of automotive parts (91%). In 2015, Mexican vehicles represented 11.4% of total vehicles sold in the US.

Impact of a NAFTA renegotiation on the automotive industry

The election of Donald Trump as the next president of the US has been deeply unsettling for Mexico. Together with proposals to build a border wall − and threats to make Mexico pay for it − the president-elect also promised to deport 11 million illegal migrants from the US, 5.7 million of which are estimated to be Mexican. Trump has also committed to renegotiate or even pull out of the NAFTA, calling it ‘the worst free trade agreement in history’. In addition, he threatened tariffs of up to 35% on goods manufactured by US companies in Mexico.

His ideas regarding trade have caused the most concern in Mexico. Since the entry into force of NAFTA, Mexican exports to the US have risen by 600% to a total of USD 320bn in 2015 − almost 80% of Mexican exports head north of the border. It is therefore not surprising that since the election, the peso (the Mexican currency) has depreciated by more than 15%. Meanwhile, Mexican GDP growth for 2017 has been revised down by the International Monetary Fund (IMF) from 2.5% to 2.18%. This is mostly due to the expectation that investments will be put on hold in 2017 as a result of the uncertainty regarding a potential change in the terms of trade between Mexico and the US.

In this respect, it should be noted that US investments abroad by auto manufacturers have been the object of particular criticism on the part of President-elect Donald Trump. For example, during the election campaign he frequently criticized Ford Motor Company's decision to move its car production to Mexico for later resale into the US. Since the election Trump has frequently reiterated his criticism and promised to undertake punitive actions while giving wide publicity to efforts to prevent US manufacturing companies from establishing production sites abroad. Additionally, the nomination of Wilbur Ross as Secretary of Commerce and of Robert Lighthizer as United States Trade Representative − both of them strong NAFTA critics − underlines the likelihood that the new administration will deliver on its promises to modify the terms of trade with Mexico.

However, the way forward for the implementation of protectionist measures on the part of the US administration will not be an easy one. It is likely to face strong opposition from the US manufacturing sector and legislators (including from the Republican Party) against modifying NAFTA. A main argument will be that the US is also dependent on exports to Mexico, which would be affected if Mexico enacted retaliatory measures, as it did temporarily in 2009 as a result of the US government's refusal to permit the entry of Mexican trucks into the US, as stipulated by NAFTA.

Regarding the automotive sector, a key consideration for the incoming administration is that, as a result of NAFTA, a high degree of supply-chain interconnectedness has developed. Approximately 40% of auto parts within automobiles sold in the US but coming from Mexico were actually produced in the US. Therefore it will be very difficult to avoid self-inflicted wounds if an open trade war starts. In a closely related matter, the utilization of the comparative advantages of the three NAFTA partners (in Mexico, a low-cost workforce with good manufacturing skills) has improved the competitiveness of the region as a whole vis-à-vis other competitors such as China. The disruption of these supply chains would, at least temporarily, impact the profitability of US automobile companies, while also hurting the US consumer who would have to pay higher prices for the same model.

Outlook for the Mexican automobile sector: trade risk to increase

Notwithstanding pressure from the US Congress and the private sector, it is likely that trade risk will increase over the next one or two years, as at least some policy actions will be implemented by the incoming US administration to change the terms of trade between both countries. The main reason for this is the high priority given to this topic in the campaign and during the transition period and, in parallel, the pressure from Trump's key constituents such as manufacturing sector workers.

In this respect, Control Risks estimates that some investments in the automobile sector will be put on hold in the short to medium term as a result of a renegotiation of NAFTA and the enactment of tariffs, as well as pressure from the US government on specific companies. This dynamic has already started: On January 3, 2017, Ford Motor Company announced the cancelation of a USD 1.6bn investment to construct an auto manufacturing plant in the state of San Luis Potosí, Mexico. However, the likely continuation of a strong dollar and a weak peso will also continue fostering Mexican exports. Additionally, auto manufacturers will further pursue taking advantage of Mexico's network of free trade agreements which give duty-free access to key markets throughout the world. Moreover, it is also likely that Mexican federal and state governments will enhance tax incentives for companies to locate in Mexico.

This being said, it is too early to say if we are witnessing the end of the 'Mexican Moment' in the automobile sector. What seems certain is that it will be on hiatus in 2017.

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